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SUBJECT: FRENCH BUDGET DEVELOPMENTS

REF: Paris 2741

¶1. (SBU) SUMMARY: The French parliament approved on August 1 one of France's largest-ever tax packages, a tax reform bill "in favor of labor, employment and purchasing power." The tax cuts are intended to improve France's competitiveness, but may have a modest impact on economic growth in the near term and will compound the central government budget deficit. The government revised its plans on cutting the civil service in 2008, and will replace two out of three (vice one out of two) retiring civil servants. The general government budget deficit (which includes the central government, the social security system and local authorities) is expected to top 2.4 percent of GDP in 2007 and drop to 2.3 percent in 2008. END SUMMARY

Lawmakers Pass the Tax Package

¶2. (U) On August 1 Parliament approved a tax reform bill "in favor of labor, employment and purchasing power." The bill notably includes tax breaks on overtime pay, introduces deductions for mortgage interest payments, reduces inheritance taxes, and lowers the maximum tax levied on all income from 60 to 50 percent (reftel). Finance Minister Christine Lagarde stressed that the tax package was, in the first instance, a tool to boost economic growth. She underscored that it was "not a gift to please the rich or a package to harm economic growth" -- an allusion to Socialist objections that the tax cuts will widen inequalities and fail to spur demand.

¶3. (U) The Parliament made only slight modifications to the original bill. Of note, deputies increased the exemption from the "wealth tax" (a tax on individuals with net assets greater than 760,000 euros) applicable to a principal residence from 20 percent to 30 percent to take into account the rise in real estate prices. Among other amendments was a measure to allow for a 50% wealth tax deduction for investments of up to 10,000 euros in small and medium-sized companies (SMEs) via mutual funds ("Fonds d'Investissement de Proximite"). The 75% wealth tax exemption on investments of up to 50,000 euros in general-interest non-profit organizations was extended to France's National Agency for Research (which supports basic and applied research, innovation, partnerships between public and private sectors and technological transfer between public and private sectors) and to registered private research organizations.

Cost of the Tax Package

¶4. (U) On July 25, Minister of Finance Lagarde confirmed that the cost of the tax package would be no more than 10-11 billion euros in 2008 (or 0.6 percent of GDP), and 13 billion euros per year once the

tax cuts are fully implemented. (Note: This estimate includes costs associated with amendments passed by the National Assembly, but not the cost of amendments approved by a Senate/National Assembly reconciliation committee subsequent to Lagarde's comments.) The Finance Minister underscored that 93 percent of the cost is concentrated on four measures that "benefit all French citizens, notably the middle class":
--Cost of tax exemptions for overtime work: 6 billion euros net, including subsequent additional social security receipts);
--Cost of tax credits on mortgage interest: 3.7 billion euros;
--Cost of reducing inheritance taxes: 2.2 billion euros.
--Cost of exempting students from paying income tax: 40 million euros.

¶5. (U) The fifth measure, which accounts for 7 percent of the total cost, is "to reconcile the French with success" by lowering the tax ceiling from 60 to 50 percent of income (cost: 600 million euros) and by exempting investments in SMEs from the wealth tax (cost: 410 million euros). Lagarde also stressed that it was necessary "to reestablish the link between success and merit" by imposing strict conditions on the award of "golden parachutes," including through fiscal disincentives and by insisting that payouts be tied to performance.

Impact of the Tax Package on Economic Growth

¶6. (U) The government argued that its tax cuts were part of a wider structural reform that will lift confidence and deliver stronger growth and purchasing power. President Nicolas Sarkozy stated that the tax package would bring "the one percent growth which is missing." Recently, Lagarde told reporters that the tax package should contribute 0.3 percent "or maybe a bit more" to the 2008 economic growth forecast of 2.5 percent.

¶7. (U) There is general consensus among French economists that the package will do more to stimulate demand than to improve the supply-side competitiveness of the French economy. The "Observatoire des Conjonctures Economiques (OFCE)" a think tank that favors demand-side measures to spur economic growth, said the tax package "will secure an economic recovery that is slow to concretize, and will bring the French economy closer to full-employment." France's "Bureau d'Information et de Previsions Economiques (BIPE)" estimates the measures will result in an additional 8 billion euros in consumption, "a substantial portion of which will fuel imports." The corporate and investment bank Natixis deemed the likely final impact on consumption "marginal" (between 0.1 and 0.2 percent of GDP per year). The bank warned that "given the situation of public finances, the implementation of a clearly pro-cyclical policy appears to be risky since France has budget-reduction objectives to satisfy."

The Government Prepares the 2008 Central Government Budget
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¶8. (U) The 2008 central government (CG) budget is based on an inflation-adjusted GDP growth rate forecast of 2.5 percent and an inflation rate of 1.6 percent. Following a government inter-departmental seminar on the 2008 CG budget, Prime Minister Francois Fillon said in late July that overall public spending would not increase in 2008, thanks in part to the non-replacement of one out of three retiring civil servants (a cut of approximately 22,700 positions). Budget Minister Eric Woerth said this was expected to generate 350-450 million euros in annual savings. A portion of the money would be used to increase remaining civil servants' salaries. Research, justice and national education are among budget priorities that would be relatively sheltered from planned cuts (though only two out of three retiring teachers will be replaced).

¶9. (U) In a recent interview, Gilles Carrez, the National Assembly Finance Committee spokesman, warned that "missions of the government must be redefined" before cutting the civil service. Polling data released on August 12 indicate that the civil service reduction is the least popular of Sarkozy's reforms, with 61% of respondents disapproving of the measure.

Government Forecasts a Decrease in the General Government Budget Deficit
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¶10. (U) The GOF forecasts that the general government budget deficit (including central government, social security system and local authorities) will decrease to 2.3 percent of GDP in 2008 from a projected 2.4 percent in 2007. President Sarkozy promised the European Commission "to do everything possible" to accelerate reduction of the public debt from 65 percent of GDP in the first quarter of 2007 to 60 percent by 2012 at the latest. The government has started to explore additional means of adjustment, including through measures to control health insurance expenditures and the creation of a social VAT. The government is also planning to pursue pension reform, but has yet to provide details.

Social Security Deficit Remains a Concern

¶11. (U) The social security system is likely to incur a 12 billion euro deficit in 2007 according to the Social Security Accounts Commission. This is almost 4 billion euros more than the deficit set in the December 21, 2006 social security financing law. The deterioration is largely due to deficits in health insurance (6.4 billion euros) and pensions (2.8 billion euros). The GOF forecasts that in ten years there will be 2 million French men and women over the age of 85, resulting in a 20% increase in the number of dependent people in France. In a July 31 visit to a health unit in Dax, France, Sarkozy announced the creation of a fifth branch of the French social security system for the aged and the handicapped (the four existing branches include health insurance, work-related accidents, family allowances, and pensions).

¶12. (U) He also announced a new levy on health care to fight cancer and Alzheimer's disease. Under the plan, patients would pay a non-refundable 0.50 euro fee on top of the price of each medication and paramedical aid, and 2 euros for medical transport such as ambulance journeys. The amount levied would be capped at 50 euros maximum per year, per person. Health Minister Roselyne Bachelot indicated that the levies are expected to result in an additional 850 million euros in revenues. Government spokesman Laurent Wauquiez made clear that the fees would finance "tomorrow's challenges," such as Alzheimer's disease, and would not be used to cover the social security deficit.

Social VAT to Finance Social Security Expenditures?
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¶13. (U) Prime Minister Fillon has invited Eric Besson, former Socialist chief economist and current State Secretary in charge of Forward Planning and Evaluation of Public Policies, to make proposals on a social Value Added Tax (VAT) to help finance health expenditures. The social VAT, vetted controversially by then-Finance Minister Jean-Louis Borloo between rounds of legislative elections in June, would consist of an increase in the VAT paid by households and a reduction in payroll taxes. Besson made an initial report to the Prime Minister in late July following fact-finding trips to Denmark and Germany (where the social VAT has been implemented). Besson should provide his final official conclusions by the end of August. The ruling majority party UMP is studying the issue separately and will present its own conclusions in September before the party's National Council. The Socialists have denounced a social VAT, saying it would hurt those with modest incomes the most.

Comment

¶14. (SBU) The Sarkozy government's tax reform package represents an important symbolic step in making the French economy more competitive, in part by loosening the 35 hour work week and through initial (albeit limited) steps to reduce the weight of the state sector in the economy. However, its short-term direct impact on economic growth is likely to be modest, and its pro-cyclical timing has come in for considerable criticism. Efforts to reduce rigidities in France's labor market, currently the subject of negotiation between unions and employers, and eventually product-market reform, will be the real tests for the Sarkozy

government. In the meantime the unpopularity of the civil service reductions and the considerable squawking over the modest health service co-payment proposals indicate the considerable challenges that lie ahead in bringing government spending under control.

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